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FINANCIAL GLOBALIZATION IMPACT ON THE CEE BANKING STABILITY

Стаття присвячена оцінці умов та тенденцій фінансової глобалізації, її впливу на банківську діяльність. Дається оцінка позитивному та негативному впливу фінансової глобалізації. Досліджуються міжнародні фінансові потоки та банківські зв'язки, що впливають на банківську стабільність країн ЦСЄ та України.
Ключові слова: фінансова глобалізація, міжнародні фінансові зв'язки, іноземні банки, національні банки.

Статья посвящена оценке условий и тенденцій финансовой глобализации, ее влиянию на банковскую деятельность. Дается оценка позитивного и негативного влияния финансовой глобализации. Исследуются международные финансовые потоки и банковские связи, которые влияют на банковскую стабильность стран ЦВЕ и Украины.
Ключевые слова: финансовая глобализация, международные финансовые связи, иностранные банки, национальные банки.

The paper is to assess the financial globalization conditions, trends and their implications on banking. It evaluates the financial globalization positive and negative impacts. International financial flows and banking linkages which influencing on CEE countries and Ukraine banking stability are studied.
Keywords: financial globalization, international financial linkages, foreign banks, domestic banks.

Introduction.

Financial globalization and cross-border capital flows are one of the key drivers of the international economy. But global financial linkages and interdependence have caused the banking and financial crisis spillovers from the USA to Europe and other countries in 2008-2009. Since 2010 the European debt crisis and Eurozone instability also triggering contagion to international financial markets, developed and emerging economies. It became obvious that financial globalization has played controversial impact on the markets and economies. The financial globalization could not manage current cross-countries asymmetries and instabilities, such as sovereign debt and budget crises, currencies and asset prices volatility, structural changes of international capital flows.

National and international banking systems of transitional and emerging economies have been one of the most dynamic areas of financial globalization in the past decades, especially in the Central and Eastern Europe (CEE), CIS countries. Financial globalization has showed a differentiated impact on the banking systems. Financial linkages with EU and CEE countries are most influential for the Ukrainian banking sector internationalization.

The research aim is to study the interaction between financial globalization and national banking systems. The objectives are to estimate channels of financial globalization influence on the CEE and Ukrainian banking. It requires assess the post-crisis interaction of financial globalization, capital flows changes, current trends on banking markets.

Research methodology and results.

The research methodology is based on the application of international macro- and microeconomic approaches as well as structural comparative analysis. A study is focused on financial globalization structural features and outcomes, its impact on changes in international capital flows and the CEE and Ukrainian banking international linkages with respect of their implications on banking stability.

A nature of financial globalization is related to the expanding internationalization of domestic financial and banking systems, broader access of countries and economic agents to international financial markets as to A,Greenspan [5] and P.Lane etc [8]. Such processes are leading to the growing integration of different financial markets, interdependence of national and international financial systems. The classical economic approach gives a vision that growing integration and interdependence should pursue effective and stable functioning of financial markets. As have been mentioned by the former chairman of the Federal Reserve System A.Greenspan, financial globalization should enforce "global financial stability and effectiveness of the global financial markets" [5, p.249]. But financial globalization now is demonstrating an integration and differentiation co-movements.

Financial globalization could not be considered as a homogenous process due to the set of systemic and structural differences between markets and countries as studied by R.Calvo [1], M.Kose, E.Prasad and K.Rogoff [7]. Financial globalization in different markets and countries could be explained based on several research approaches such as:

1) A model of the national economy and finance inclusion into global. Researchers are applying different models of interaction of the national and global financial economies. From one side, models based on the dominance of global finance and economy over national could be considered as globalist ones. From the other side, models known as an open-market economy are focusing on interaction of external and internal factors of the countries' trade and finance linkages. The international financial linkages in such models are considering differently.

2) Study of liberalization as financial globalization driving factor. Liberalization means lifting limitations on the cross border capital flows and banking transactions. It plays a different impact on countries. Liberalization is more positive for developed economies which have open access to international financial markets. For developing and emerging economies with less institutional and regulatory strength liberalization often bring negative impact such as capital outflows, domestic banking dependence on foreign capital. Therefore differences in financial liberalization across countries may influence on financial globalization extent.

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3) Institutional and structural approach to financial globalization. It is based on the major structural issues such as capital flows structure, foreign capital in banking and financial sector, cross-border M&A in banking, a harmonization of banking and financial regulation.

Financial globalization could be defined as a complex process of increasing interdependence of the national financial systems with international, deeper structural integration of financial institutions and markets, broaden access of economic agents to international financial markets, growing influence of the global forces to the national finance.

International capital flows and stocks of foreign assets and liabilities are reflecting a scale of cross-countries financial linkages, therefore playing a key role for financial globalization. Financial globalization extent and effects for different countries could be influenced by combination of systemic financial and macroeconomic conditions such as:

1) Type of financial system – market-based or bank-based; liberalized market-based systems are more open to capital flows and broader access to international markets.

2) Developed economic and financial systems would be a background of effective allocation of financial liquidity.

3) Economic and financial system capacity to absorb external financial shocks, regulate capital inflows and outflows will pursue balanced external financial linkages and stability.

4) Political stability and institutional development, including rule of law and contracts enforcement, will insure foreign investor's rights and external debt settlements.

5) Effective fiscal and monetary policy should support the domestic financial balances and currency stability.

6) Flexible exchange rates regime and capacity to withstand international currencies fluctuations would absorb speculative financial attacks.

7) Coordinated development of foreign trade and capital flows should support financial stability.

Financial globalization under noted conditions would bring positive effects. Benefits of financial globalization are for balancing cross-countries financial linkages, effective utilization of external financial resources. Major effects of financial globalization could be considered in connection with national banking and financial systems development, preserving financial stability:

1) More effective allocation of financial liquidity through competitive access to international markets gives a possibility to overcome the liquidity constraints of the domestic banking system in terms of the debt provision (size, maturity, interest, risk hedging).

2) Debt and liquidity risks diversification through the hedging and transfer to international markets via securitization.

3) Better conditions of international borrowing would support national economic growth.

4) Domestic financial infrastructure development in line with the international.

5) IT and financial technologies transfer to national banking systems, access to international payment and securities trading systems.

Financial globalization benefits are focusing on additional financial liquidity from the international markets on more competitive conditions in comparison with domestic. But it also sets the certain dependence from the international funding which may turn into risks if international markets will go into excessive volatility or crisis.

Therefore along with its benefits, a financial globalization risks should be considered such as:

1) Contagion and international spillover are a specific mechanism of cross-border transposition of the national or international financial markets distresses – fluctuations, shocks, crises, risks, value change of financial assets, exchange rates change – to other national financial markets or other segments of international financial markets.

2) Markets speculative movements – changes of financial assets prices or investors preferences resulting from the international markets behavior which targeting short-term gains and not run by the market fundamentals.

3) Monetary and macroeconomic impact of capital flows: large capital inflows could cause the excessive monetization of the host country economy, credit boom and finally inflation and exchange rates changes. In turn large capital outflow may slowdown the economy and put devaluation pressure on domestic currency.

4) Home countries macroeconomic problems such as economic depression or banking credit crunch may call for capital reversal or divestment – recall the invested capital, which may affect slowdown the host country economy.

5) International markets liquidity problems may limit availability and price of debt and equity capital demanded by specific country, put strict conditions for accumulated debt servicing and restructuring.

Financial globalization impact would be studied while an appropriate measuring could be applicable. Different studies are suggesting a financial globalization measuring using a country capital flows or external investment position as a basic indicators. For example, an approach suggested in the IMF working paper by P.Lane and others could be considered as a most acceptable [ ]. Such methodology provides calculation of financial globalization index as a country international investment position (a sum of external assets and external liabilities) divided to GDP, all nominated in the current US dollars.

It could be considered a few methodological issues related to such index. First, external assets and liabilities could be measured as a value in balance prices (mostly historical) and do not reflect their price change. But GDP could be measured in current US dollars and reflect actual prices. Second, the international investment position could be balanced, or positive, or negative. The last case would reflect the dominance of external liabilities, which may be considered primarily as a negative result of globalization. Third, such index most suitable for the relatively stable periods of international and domestic financial development, Index changes may be influenced by the both emergency external borrowing and GDP slowdown during the crisis times.

Financial globalization trends and their implications on the banking systems could be studies using an example of several CEE countries and Ukraine. Poland, Czech Republic and Hungary could be selected among the CEE countries due to the following reasons: geographical neighbouring, comparable level of economic development, comparable type of economies as finished transformation and currently as emerging market economies, similar bank-based financial systems, comparable structure of international capital flows.

Financial globalization index calculated for Poland, Czech Republic and Hungary using the methodology of P.Lane and others [ ], shows few similarities and differences:

***Table 1.* Financial globalization indexes for selected CEE countries**

	2005	2006	2007	2008	2009	2010
Poland	1,03	1,18	1,30	0,97	1,37	1,31
Czech Republic	1,50	1,63	1,79	1,48	1,80	1,72
Hungary	1,74	3,01	3,86	4,06	5,40	5,10

Source: calculations based on IMF data [6]

Few similarities in financial globalization index movement across countries could be explained as the following:

1) The financial globalization indexes for all three countries have shown a general uphill trend since countries have joined EU in 2005. But index level and the trends extent are different in all countries.

2) The financial globalization indexes for countries (except Hungary) have relatively decreased in 2008 while peak of the global financial crisis and more increased for all countries in 2009 after crisis. The last move could be explained as a combination of external debt growth during the crisis and slowdown of GPD (except Poland).

3) The financial globalization indexes in 2010 are slowly decreased back to pre-crisis level which could be caused by the tightening the external debt policies and respective slowing of external liabilities.

Indexes differences looks more related to the overall economic and financial situation in respective countries then by financial globalization impact. First, financial globalization indexes for Poland and Czech Republic have a moderate volatility and grew up in a relative range of 15 to 30 % in 2010 to 2005 level. Second, the index increased for Hungary in a range of around 300 % in 2010 to 2005, which could not be explained only by globalization impact. Third, for Hungary the largest increase of index has been occurred in 2006-2007 before the global financial crisis. Most believable it could be explained by the massive emergency lending from the EU and international financial institutions to Hungary at that time in response to the country's budget and financial crisis. Forth, the global crisis influence to Hungary have pursued EU and IMF for additional emergency lending, results of which has been reflected in the further substantial growth of foreign liabilities and financial globalization index in 2008-2010.

The case of Hungary shows that financial globalization index does not eliminate an influence of pure domestic economic and financial factors, which causing the unbalanced growth of external liabilities and negative international investment position. Therefore the financial globalization index should be studied in combination with the net balance and structure of the international investment position.

An assessment of the factors of the financial globalization index for Ukraine went to similar conclusions. The index movements are influencing by both capital flows and increasing of external liabilities.

***Table 2.* Financial globalization indexes for Ukraine**

	2005	2006	2007	2008	2009	2010
Ukraine	1,06	1,24	1,49	1,40	2,25	1,98

Source: calculations based on IMF data [6]

For example, an increase of index in 2006-2007 may be explained by the large inflow of capital mostly due to foreign acquisitions of the shares of the large Ukrainian banks. It could be attributed to financial globalization and reflects interdependence of domestic and international banking. But index movements in 2009 have been caused by the emergency IMF lending and respective increase of foreign liabilities at the time of crisis-driven large GDP decline.

Financial globalization influence onto the CEE and Ukraine banking developments would be studied in several directions while taking into consideration rebalancing of cross-border financial flows, foreign capital penetration in the banking sector, structural changes in banking, external financing of the foreign affiliates, Eurozone debt crisis impact.

Capital flows trends in 2009-2011 would be considered as rebalancing because the substantial changes in value, composition, major forms and directions. Asset prices bubble which stimulate FDI, stock and debt market excessive growth was preceding the global crisis. Since 2009 capital flows have declined in volumes and changed in patterns.

Rebalancing of the international capital flows could be considered such as:

- financial assets value change due to the international financial markets slowdown and financial risk hedging cost;
- changing balance of inflows and outflows of capital, increased outflow of foreign portfolio and short-term capital;
- switch from capital inflow in some countries to "sudden stop" of capital movement during global crisis;
- spread of negative equity as result of drop down of some assets price below the related liabilities, such as real estate market price below residual mortgage debt, underlined assets value decrease in case of securitization;
- post-crisis slowdown of capital flows in developed economies and growth from the emerging economies;
- raising cost of the foreign-currencies denominated external and domestic debt servicing for the economies with devaluated currencies and less demand for external debt;
- bad assets on the banks' balance sheets.

External financial shocks and capital flows structural changes have affected the countries' balance of payments, international investment position, exchange rates volatility, national banking systems stability.

National financial and banking systems stability could be considered as a capacity to allocate effectively financial resources from savers to borrowers, to manage financial risks and to absorb external financial and economic shocks. Banking stability is a systematic capacity which largely dependable on the banks capitalization, assets quality and liabilities management. Ffinancial globalization influencing on the national banking systems stability foremost via presence and performance of the foreign owned banks.

Foreign capital penetration in the banking sector of the CEE countries and Ukraine are considering as a key form of financial globalization and European financial integration. But foreign capital penetration is different.

The European Central Bank estimate a foreign branches and affiliates share measured by the assets in 2010 are in Hungary – 58 %, Poland – 69 % and Czech Republic – 92 % of the respective banking system [2, p.20]. Comparing such data with financial globalization index, it can be seeing that foreign capital penetration looks opposite. For example, Czech Republic has much smaller financial globalization index then Hungary, but the highest level of foreign banking penetration in 92 % comparing with much lover 58 % in Hungary.

Foreign capital share in the national banking systems of the European emerging economies, new EU member states and CEE countries have not a same extent and trend, but specific for each country. Foreign capital recipro-

cation in the each country banking system have been influenced by the speed of economic reforms, privatization pace, historical and socio-economic conditions etc.

Prospects of further foreign participation in the national banking systems now are dependable to general trends of the European banking integration. Two major trends could be noticed in such respect:

1) Ongoing decrease of the banks cross-border mergers and acquisitions (M&A) in the European financial area. For example, the data of cross-border M&A with participation of the Euro-area banks by the transactions total value was: in 2005 – 30 billions EUR, 2006 – 11 billions, 2007 – 14 billions, 2008 – 52 billions, 2009 – 9 billions, 2010 and 2011 – around 2 billions each year. [3, p.S15] It means, that currently Euro area banks have limited further integration activities and concentrating on the issues of improving of quality of assets, restructuring of balance sheets, further capitalization in line with Basel III requirements. Such measures have to improve banking stability.

2) Actual liquidity limits and need for the recapitalization of the European banks in order to meet Basel III capital requirements, therefore less motivation for other markets expansion.

European banks mostly have used a centralized liquidity provision model to finance their affiliates in the CEE and CIS. Liquidity have been channeled from the parent banks to the foreign affiliates as interbank lending facilities, subordinated loans, syndicated loans, affiliates notes and bonds investments. Low liquidity cost on the European markets have provided an opportunity to raise a higher margins on foreign markets and expand foreign currencies denominated lending. But during the global crisis it have been turned into accumulation of bad loans and asset price deterioration if foreign affiliates.

European banks affiliates in the CEE and Ukraine have been faced with the problem of external financing in order to withstand global financial crisis and Eurozone instability. Such problem h as a several aspects: 1) foreign-owned banks currency denominated bad loans and bank external liabilities problems; 2) parent banks decrease or withdraw a liquidity provision to foreign affiliates, therefore they should go to other liquidity sourcing; 3) an overall limitation of the banks access to international financial liquidity. Such situation certainly affects foreign-owned and domestic banks performance.

***Table 3.* Ukrainian banks external loans and bonds – a balance of received and paid amounts a year, mln. USD**

	2005	2006	2007	2008	2009	2010	2011
Banks – external loans and bonds balance	1625	4079	10526	7586	-3272	-2010	-3600

Source: compiled based on data [13], [14]

The data shows that amounts of external loans and bonds to Ukrainian banking system have grew significantly since 2005 at the time of the massive development of foreign-owned banks. Capital inflow has fed a rapid credit expansion, assets and real estate prices increase in Ukraine. A trend has changed as result of the global financial crisis and turned to negative balance of capital flows to banks in the country. It has a substantial implication on the banks liquidity and performance, the Ukrainian banking system stability.

The balanced approach to managing capital inflows and outflows, external sourcing of liquidity for the national banking sector, the foreign banks capitalization and performance on the domestic market should be set forth in order to limit negative and support positive impact of financial globalization on the emerging economies' banking systems. The emerging markets banks further capitalization in order to meet Basel II and Basel III requirements should be supported by national regulators in order to assure financial stability under limited accessibility of external liquidity.

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